IN THE

# SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1955.

No. 610 75

MAX PUTNAM AND ELIZABETH PUTNAM,
PETITIONERS,

VS.

COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT.

## PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT.

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## PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT.

Petitioners pray that a Writ of Certiorari issue to review the judgment of the United States Court of Appeals for the Eighth Circuit entered in the above entitled proceeding on August 11, 1955.

## CITATIONS TO OPINIONS BELOW.

The findings of fact and opinion of the Tax Court of the United States (R. 16-24) is reported unofficially in

*13 T. C. M. 458.* The opinion of the Circuit Court of Appeals printed in Appendix A hereto, *infra*, p. 9, is reported in 224 F. 2d 947 (C. C. A. 8th).

## JURISDICTION.

The judgment of the Circuit Court of Appeals was entered on August 11, 1955, Appendix A, p. 19, *infra*. The time for filing Petition for Writ of Certiorari was, on November 9, 1955, extended to and including January 7, 1956. Appendix A, p. 20, *infra*. The jurisdiction of this Court is invoked under *28 U. S. C., Section 1254*.

## QUESTION PRESENTED.

A corporation borrowed from a bank, and the taxpayer petitioner co-signed the corporate notes as guarantor. The corporation's business was not successful, and its assets were sold. The proceeds of the sale did not cover its indebtedness, and the taxpayer petitioner had to pay the corporation's notes to the bank. Were the taxpayer petitioner's losses non-business debts under Section 23(k)(4) of the United States Internal Revenue Code of 1939, or did such losses result from a transaction entered into for profit within the meaning of Section 23(e)(2) of the United States Internal Revenue Code of 1939?

## STATUTES.

The pertinent provisions of the United States Internal Revenue Code of 1939, adopted by Act of February 10, 1939, Ch. 2, 53 Stat. 1-504 and Regulations applicable thereto are set forth in Appendix "B."

## STATEMENT.

Petitioners duly filed their petition for a redetermination of their personal income tax liability with the Tax Court of the United States for the calendar years 1947 and 1948. The Tax Court of the United States had jurisdiction over the proceeding in the first instance, in accordance with Section 272(a) of the United States Internal Revenue Code of 1939. The Tax Court of the United States rendered its findings of fact and opinion on May 12, 1954 (R. 16-24), and entered its decision on May 13, 1954 (R. 24), on the basis of the pleadings, oral testimony, arguments and briefs.

It was determined by the Tax Court of the United States that the payment by petitioner Max Putnam of the sum of $9,005.21 as guarantor on notes of Whitehouse Publishing Company, a corporation, which corporation was fully liquidated at the time of such payment, gave rise to a non-business bad debt deduction under Section 23(k)(4) of the United States Internal Revenue Code of 1939. The Tax Court of the United States did not consider petitioners' argument that the performance by petitioner Max Putnam of his obligations as guarantor for Whitehouse Publishing Company gave rise to a loss resulting from a transaction entered into for profit within the meaning of Section 23(e)(2) of the United States Revenue Code of 1939 (R. 24).

With the finding of the Tax Court that the loss resulted in a non-business bad debt deduction under Section 23(k)(4), the court below agreed. However, the Circuit Court did consider petitioners' alternative argument that the losses resulting from the performance of the guaranty were deductible under Section 23(e)(2). The Circuit

Court rejected petitioners' arguments in that regard and concluded that the great weight of authority favored the treatment of the loss as a non-business bad debt deductible as a short-term capital loss under Section 23(k)(4), and that such loss did not come under the provisions of Section 23(e)(2).

In so holding, the court below refused to follow the decisions handed down by three other Circuits in which contrary decisions involving the same basic factual circumstances were reached.

*Pollak* v. *Commissioner*, 209 F. 2d 57 (C. C. A. 3d).
*Edwards* v. *Allen*, 216 F. 2d 794 (C. C. A. 5th).
*Cudlip* v. *Commissioner*, 220 F. 2d 565 (C. C. A. 6th).

## REASONS FOR GRANTING THE WRIT.

1. The action of the court below in holding that a loss sustained by a guarantor of a corporate obligation at a time when the corporation has been fully liquidated, gives rise to a non-business bad debt deduction under Section 23(k)(4) of the United States Internal Revenue Code of 1939, rather than a loss from a transaction entered into for profit under Section 23(e)(2), creates a direct conflict between the Eighth Circuit and the Third, Fifth and Sixth Circuits.

*Pollak* v. *Commissioner, supra.*
*Edwards* v. *Allen, supra.*
*Cudlip* v. *Commissioner, supra.*

2. The action of the court below in holding that a bad debt can arise against a corporation which had become insolvent and which had been fully liquidated is also contrary to the principles enunciated by the Second Circuit in *Fox* v. *Commissioner*, 190 F. 2d 101. In the Fox case the court

realistically points out that a debt can arise only where there is an expectation of recovery. No debt arises simply from the making of a guaranty, but can only arise when the guaranty is performed. If at the time of performance of the guaranty, circumstances make recovery an impossibility, it is likewise impossible for a debt to arise or to come into existence. A bad debt deduction may arise only where a debt exists. In the Fox case the court said:

> "It is utterly unrealistic to consider the payment as one made in any expectation of recovery over or of any legal claim for collection. Actually it was merely the fulfillment of her contractual obligation of the earlier date. The bad debt provision thus had no direct application; only by straining the statutory language can we erect here a disembodied debt against an insolvent and long dead debtor."

3. The decision of the Circuit Court sustaining the action of the Tax Court of the United States in this proceeding is believed to be the first case of its kind to reach the United States Supreme Court. In view of the direct conflict between the decision of the court below and the Circuit Courts for the Third, Fifth, and Sixth Circuits, and in view of the completely unrealistic holding of the court below that a debt can arise against an insolvent and fully liquidated corporation where there is no hope whatsoever of recovery, which holding is in conflict with the Second Circuit in *Fox* v. *Commissioner, supra*, it is in the public interest that the Supreme Court of the United States review the decision of the Eighth Circuit herein.

4. The court below in holding that the weight of authority is contra to the decisions in *Pollak* v. *Commissioner, supra, Edwards* v. *Allen, supra,* and *Cudlip* v. *Commissioner, supra,* makes reference to the following cases:

*Burnet* v. *Clark*, 287 U. S. 410.

*Commissioner* v. *Smith*, 203 F. 2d 610 (C. C. A. 2d).
*W. F. Young, Inc.*, v. *Commissioner*, 120 F. 2d 159 (C. C. A. 1st).

The cases relied upon by the court below are not opposed to the Circuit Court decisions cited and relied upon by the petitioner herein. The *Burnet* case arose in connection with a claimed net operating loss carry-forward which the taxpayer sought to deduct in subsequent years. It is to be noted that the taxpayer therein was permitted to deduct the losses in the year in which they were suffered, but under the statutes permitting the carry-forward of a net operating loss, the taxpayer failed to establish that the losses were the result of the operation of a trade or business regularly carried on by the taxpayer. The statute with which the court was there concerned was not the same or similar to Section 23(é)(2) of the United States Internal Revenue Code of 1939. As a consequence, the case of *Burnet* v. *Clark*, *supra*, was not in point with reference to the issues before the court below.

The cases of *Commissioner* v. *Smith* and *W. F. Young, Inc.*, v. *Commissioner*, *supra*, involved loans and advances made by a taxpayer petitioner to a corporation in which the petitioner was a stockholder. There was no question in either of those cases as to the existence of a debt; and the only question there involved was whether or not the debt was of a business or non-business nature.

As a consequence, it is apparent that the cases cited by the court below as representing the great weight of authority were not even remotely in point on the issue here involved.

## CONCLUSION.

For the foregoing reasons, this Petition for Writ of Certiorari should be granted.

Respectfully submitted,

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## APPENDIX A.

UNITED STATES COURT OF APPEALS.
FOR THE EIGHTH CIRCUIT.

Decided August 11, 1955.

**Docket No. 15,190.**

MAX PUTNAM AND ELIZABETH PUTNAM,
PETITIONERS,

VS.

COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT.

**Petition to Review Decision of the Tax Court of the United States.**

Richard E. Williams, for petitioners, Dudley J. Godfrey, Jr., Special Assistant to the Attorney General (H. Brian Holland, Assistant Attorney General, and Ellis N. Slack and Joseph F. Goetten, Special Assistants to the Attorney General, were on the brief), for respondent.

Before Gardner, Chief Judge, and Woodrough and Thomas, Circuit Judges.

Thomas, Circuit Judge: Petitioners, Max Putnam and Elizabeth Putnam, seek a review and reversal of a decision of the Tax Court of the United States (13 T. C. M. 458; T. C. Memo. 1954-37) entered on May 13, 1954, sustaining the determination of the Commissioner of Internal Revenue that there was a deficiency in their income tax return for the year 1947 in the sum of $1,411.16 and for the year 1948 in the sum of $2,121.56.

Petitioners contend here, as they did in the Tax Court, that they were entitled in their 1947 return to a deduction of $8,492.32 as a business bad debt deduction under Sec. 23(k)(1) of the Internal Revenue Code of 1939, and in their 1948 return to a deduction of $9,005.21 under Sec. 23(k)(1), *supra*, or as a loss resulting from a transaction entered into for profit within the meaning of Sec. 23(e)-(2) of the Internal Revenue Code of 1939. Instead the Commissioner determined that the losses sustained in 1947 and 1948 constituted non-business bad debts deductible only as short-term capital losses under Sec. 23(k)(4) of the Internal Revenue Code. The Tax Court sustained the determination of the Internal Revenue Commissioner, and thereafter petition to review such decision was filed.

The alleged errors of the Tax Court relied on by the petitioners are that:

The court erred in holding that the debts owing petitioner, Max Putnam, which became worthless in 1947 and 1948 were non-business debts, in that (a) the losses resulting from the worthlessness of such debts were proximate to and incurred in petitioner's business as a practicing attorney; (b) that the worthlessness of such debts (if debts existed) was deductible as a loss under said Sec. 23(k)(1); or (c) that the loss suffered by petitioner as a guarantor on the notes he was compelled to pay resulted from a transaction entered into for profit within the meaning of Sec. 23(e)(2) of said Internal Revenue Code.

**(Facts.)**

Petitioners, husband and wife, reside in Des Moines, Iowa. They filed joint income tax returns for the years 1947 and 1948. Since 1931 the petitioner, Max Putnam, has been continuously engaged in the practice of law in Des Moines.

The transaction with which we are concerned resulted from the organization of the Whitehouse Publishing Company. In 1944 Putnam became legal counsel for Local 441 of the Railway Workers Union at Des Moines, continuing in that capacity until 1949. Through one Gilbert, business agent of the Union, he met Meredith Case, editor of the Des Moines Federationist, a weekly labor newspaper, which had the endorsement of the local trades and labor assembly, but which was controlled by Leo Quinn, business manager of the Local Teamsters' Union, A.F.L., and other Union interests.

On August 17, 1946, the Whitehouse Publishing Company was incorporated for the purpose of carrying on a general printing and publishing business. Its capital stock consisted of 15 shares of the par value of $100 each, five shares of which were issued to petitioner, and five shares each to Case and Quinn. While Case and Quinn had a reputation for honesty and integrity, they had no means or cash available to put into the corporation. For himself and on behalf of Case and Quinn, Putnam transferred a lot valued at $1,000 to the corporation, paid $5,500 for the construction of a building thereon; and made a cash contribution of $1,500 as working capital. He also guaranteed the payment for supplies purchased by Whitehouse and of its employees' salaries.

Case and Quinn agreed to and did execute to petitioner their promissory notes, each equal to one-third of the cost of the real estate and the building, and of the cash which Putnam had put into the company. In November, 1946, these notes aggregated the sum of $8,492.32 and were secured by pledge of the Whitehouse Publishing Company stock owned by Case and Quinn. Their debts to the petitioner became worthless in 1947. In February, 1947, Case's notes to petitioner were cancelled and his shares of stock

in Whitehouse were assigned to petitioner who was to receive promissory notes in like amount from Whitehouse. In July, 1947, Quinn's notes to petitioner were cancelled and his shares of stock in Whitehouse were assigned to petitioner, who was to receive notes for the same amount from Whitehouse. Nothing in the record indicates whether petitioner ever received such notes from Whitehouse.

On August 20, 1946, petitioner and Whitehouse Publishing Company borrowed $12,075 from the Central National Bank and Trust Company of Des Moines for the use of the corporation and signed a promissory note therefor as co-makers.

Petitioner, on November 13, 1946, borrowed the sum of $3,500 which he made available to the Whitehouse Publishing Company.

In March, 1947, Whitehouse and petitioner borrowed from the bank the further sum of $5,000 and signed a promissory note therefor as co-makers.

This publishing enterprise was not successful. By July, 1947, the publishing company's only assets were its building and equipment. It was receiving some income from payments on orders for a publication it had printed, but at the same time its indebtedness amounted to $13,500. Its building was sold for $7,000 and it ceased to do business. From the $7,000 thus received $5,000 was used toward paying off the promissory note of August 20, 1946, and $2,000 was turned over to the petitioner for the advances he had made.

In December, 1948, petitioner paid to the bank the balance of $3,500 due on the note of August 20, 1946, and the $5,000 note of March, 1947, which notes with interest totaled the sum of $9,005.21.

**(Code Provisions.)**

The pertinent statute in determining the issues here is Sec. 23 of the Internal Revenue Code of 1939 (26 U. S. C., 1952 Ed., Sec. 23), which reads as follows:

"Sec. 23. Deductions from Gross income.

* * * * * * *

"(e) Losses by Individuals. In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—

"(1) if incurred in trade or business; or

"(2) if incurred in any transaction entered into for profit, though not connected with the trade or business; * * *

* * * * * * *

"(k) Bad Debts.—

"(1) (as amended by Section 124(a) of the Revenue Act of 1942, and Section 113 of the Revenue Act of 1943) General rule.—Debts which become worthless within the taxable year; * * * This paragraph shall not apply in the case of a taxpayer, other than a corporation, with respect to a non-business debt, as defined in paragraph (4) of this subsection.

* * * * * * *

"(4) (As added by Section 124(a) of the Revenue Act of 1942, *supra*) *Non-business debts.*—In the case of a taxpayer, other than a corporation, if a non-business debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered as a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 6 months. The term 'non-business debt' means a debt other than a debt evidenced by a security as defined in paragraph (3) and other than a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business."

In this publishing venture which turned out so unfortunately for the petitioner, Max Putnam, there is no question but that he sustained the losses for which he claims deductions in the joint income tax returns of himself and his wife for the years 1947 and 1948.

However, the questions we must answer are whether the losses which he suffered were proximate to and incurred in his business as a practicing attorney and whether the balance of the debt he was compelled to pay to the bank was connected with a transaction entered into for profit, or a "non-business" debt.

Petitioner does not contend that he was in the business of investing in, organizing, and financing business enterprises as such. He was a practicing attorney. He contends that all of his activities connected with various enterprises, including the advances and loans to Case and Quinn, were part of his activities as a lawyer directed toward the betterment of attorney-client relationships and for increasing his clientele.

**(Cases Cited by Taxpayer.)**

To show that the loss of $8,492.32 resulting from the debts owing him by Case and Quinn were proximate to and incurred in his business as a practicing attorney he calls attention to two cases from the Tax Court: *Fisher Brown et al.* v. *Commissioner*, 9 T. C. M. 1045 (1054); and *Hogan* v. *Commissioner*, 3 T. C. 691; also cited is the case of *Maloney, Collector*, v. *Spencer*, 9 Cir., 172 F. 2d 638. A reading of these cases does not convince us that the situations in them are analogous to the situation here, as petitioner contends. The loans to Case and Quinn were not proximate to or incurred by him as an attorney; they were not essential to his law practice. *Burnet* v. *Clark*, 287 U. S. 410; *Omaha National Bank* v. *Commissioner*, 8

Cir., 183 F. 2d 899. His loss from the debts owing him by Case and Quinn was not "attributable to the operation of a trade or business regularly carried on by the taxpayer." *Dalton* v. *Bowers*, 287 U. S. 404, 409.

In the cases cited, *supra*, by the petitioner the taxpayers advanced money to or guaranteed loans for business which were closely associated with their various business enterprises. For instance, in the *Fisher Brown* case the taxpayer was a wholesale distributor of furniture. He advanced and loaned money to his son-in-law, a manufacturer of furniture. The business failed and taxpayer's loss was treated as a business bad debt under Sec. 23(k)(1) of the Internal Revenue Code, the Tax Court saying: "We conclude that the petitioner made the advances to Marin as loans for purposes connected with his business as a distributor of furniture * * *" We fail to see the analogy and hold this contention to be without merit.

The facts here bear a striking similarity to the facts in the case of *Omaha National Bank* v. *Commissioner*, 8 Cir., 183 F. 2d 899. There L. F. Crofoot, deceased before the case reached the appellate court, and for whose estate the bank was special administrator, was a practicing attorney in Omaha, Nebraska, during all the period involved. In order to protect loans he had made to one Rosso, a restaurant and tavern operator, the business was incorporated with a capital stock of $40,000, and finally the taxpayer owned 333 shares of the stock for which he had paid $33,450. From its inception the business did not prosper, and finally the corporate assets, including the building, were sold for $15,000. After the distribution of the assets there was still owing the taxpayer on money loaned to the corporation the sum of $10,407.90, which he claimed as a business bad debt. The Tax Court held that his losses were

not suffered in his "trade or business"; that the petitioner was not engaged in the restaurant business, which was conducted by a corporation; and that it was not his individual business. One of the principal cases relied on by the Tax Court was that of *Burnet* v. *Clark*, 287 U. S. 410, wherein it was said: "The unfortunate endorsements were not part of his ordinary business but were occasional transactions intended to preserve the value of his investment in capital shares." This court affirmed, holding that the loss suffered by the taxpayer was not incurred "in his trade or business." See, also, *Nicholson* v. *Commissioner*, 10 Cir., 218 F. 2d 840 (240); *Chicago Title & Trust Co.* v. *United States*, 7 Cir., 209 F. 2d 773; *Commissioner* v. *Smith*, 2 Cir., 203 F. 2d 310, cert. den. 346 U. S. 816. The loans advanced to Case and Quinn were not business bad debts allowable as deductions under Sec. 23(k)(1), but the loss of the $8,292.32 which taxpayer sustained in 1947 constituted a non-business bad debt deductible only as a short-term capital loss under Sec. 23(k)(4) of the Internal Revenue Code of 1939.

Finally we consider whether the losses of petitioner resulted from a transaction entered into for profit within the meaning of Sec. 23(e)(2), "though not connected with the trade or business."

We have already considered that the loans made to Case and Quinn resulting in the loss of $8,492.32 were non-business bad debts deductible as short-term capital losses. These loans cannot be considered as transactions entered into for profit within the meaning of Sec. 23(e)(2). Only if the publishing venture had proved successful would there have been any chance to be reimbursed by Case and Quinn. At no time had they anything of value from which reimbursement could be had. Petitioner admits they were "judgment-proof."

**(Notes Signed As Co-maker.)**

We next consider whether the loss which resulted in 1948 comes under Sec. k (e) (2). In December, 1948, taxpayer was compelled to pay to the bank the sum of $9,005.21. The amount represented the balance of $3,500 due on the $12,075 note of August 20, 1946, and the $5,000 note executed in March, 1947, both of which notes petitioner signed as co-maker with the Whitehouse Publishing Company.

Very little discussion is needed on this point. It is true that in the case of *Cudlip* v. *Commissioner*, 6 Cir., 220 F. 2d 565, that court reversed the decision of the Tax Court. Cudlip was an attorney, and his law practice had to do principally with banks corporations and business ventures. He became interested in WiRecorder Corporation, and in 1947 with two others he became a guarantor on the corporation's note for $90,000. The corporation was not successful and on November 23, 1949, notified the bank that it was unable to meet its obligation upon the note. Whereupon, in accordance with his guaranty agreement, Cudlip paid the bank on November 25, 1949, $30,000 plus $200 of interest due on the note. The other guarantors likewise paid $30,000 each on the note. The corporation was insolvent; its corporate existence terminated on December 13, 1949; and petitioner Cudlip never recovered anything from the corporation. The Sixth Circuit, reversing the decision of the Tax Court (12 TCM 1290), stated that the loss incurred resulted from a transaction entered into for profit under Sec. 23(e)(2). In its opinion the court said that "Taxation is concerned with realities, and * * * the contentions here advanced by the Commissioner are completely unrealistic," and remanded the case for allowance of the claimed deduction under Sec. 23(e)(2), relying particularly upon *Pollak* v. *Commissioner*, 3 Cir.,

209 F. 2d 57, 58, and *Allen* v. *Edwards*, D. C. Ga., 114 Fed. Supp. 672, 674 (affirmed by the Fifth Circuit in *Edwards* v. *Allen*, 216 F. 2d 794). In a vigorous dissenting opinion, Judge Stewart stated: "Yet, until the *Pollak* and *Allen* cases, and today's decision in this case, the debt so arising has consistently been considered nonetheless deductible as a bad debt, although it became worthless immediately upon its ripening from a secondary obligation into a debt." Citing Cases.

Considerable diversity of opinion exists among the different circuits as to deductions from gross income under Sec. 23 of the Internal Revenue Code. We find no case in the Supreme Court overruling its decision as to a non-business bad debt loss since the publication of its decision in *Burnet* v. *Clark*, 287 U. S. 410. In spite of the recent opinion of the Sixth Circuit in the *Cudlip* case, *supra*, the great weight of authority is that a transaction such as that of Whitehouse Publishing Company and petitioner with the bank, wherein petitioner was compelled, as co-maker or guarantor, to pay the balance due on the notes to the bank in the sum of $9,005.21, including interest, is a non-business bad debt deductible as a short-term capital loss under Sec. 23(k)(4), and that such loss does not come under the provisions of Sec. 23(e)(2) where deduction is allowable "if incurred in any transaction entered into for profit, although not connected with the trade or business." See and compare *Burnet* v. *Clark*, 287 U. S. 410; *Commissioner* v. *Smith*, 2 Cir., 203 F. 2d 610 (310); *W. F. Young, Inc.*, v. *Commissioner*, 1 Cir., 120 F. 2d 159.

The decision of the Tax Court as to a deficiency in the petitioners' income tax returns for 1947 and 1948 in the sums of $1,411.16 and $2,121.56, respectively, is, therefore, Affirmed.

(JUDGMENT.)

UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT.

SEPTEMBER TERM, 1954.

**No. 15,190.**

Thursday, August 11, 1955.

MAX PUTNAM AND ELIZABETH PUTNAM, PETITIONERS,

VS.

COMMISSIONER OF INTERNAL REVENUE.

**Petition to Review Decision of the Tax Court of the United States.**

This cause came on to be heard on the Petition to review a decision of The Tax Court of the United States entered May 13, 1954, determining that there were deficiencies in the income tax returns of the petitioners for the years 1947 and 1948, and was argued by counsel.

On Consideration Whereof, It is now here Ordered and Adjudged by this Court that the decision of the said Tax Court in this matter be, and the same is hereby, affirmed.

And it is further Ordered by this Court that the petition to review in this matter be, and the same is hereby, dismissed.

/s/ E. E. Koch,
Clerk.

August 11, 1955.

SUPREME COURT OF THE UNITED STATES.

October Term, 1955.

**No.** .....

MAX PUTNAM AND ELIZABETH PUTNAM,
PETITIONERS,

VS.

COMMISSIONER OF INTERNAL REVENUE.

**Order Extending Time to File Petition for Writ of Certiorari.**

Upon Consideration of the application of counsel for petitioners,

It is Ordered that the time for filing petition for writ of certiorari in the above-entitled cause be, and the same is hereby extended to and including January 7th, 1956.

/s/ Tom C. Clark,
Associate Justice of the Supreme Court of the United States.

Dated this 9th day of November, 1955.

## APPENDIX B.

### Internal Revenue Code of 1939.

Sec. 23. Deductions from Gross Income.

In computing net income there shall be allowed as deductions:

* * * * * * *

(e) *Losses by Individuals.*—In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—

(2) if incurred in any transaction entered into for profit, though not connected with the trade or business; * * *

* * * * * * *

(k) *Bad Debts.*—

(4) (As added by Section 124(a) of the Revenue Act of 1942, *supra*) *Non-business debts.*—In the case of a taxpayer, other than a corporation, if a non-business debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 6 months. The term "non-business debt" means a debt other than a debt evidenced by a security as defined in paragraph (3) and other than a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

(26 U. S. C., 1952 Ed., Sec. 23.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

Sec. 29.23(e)-1. *Losses by Individuals.*—Losses sustained by individual citizens or residents of the

United States and not compensated for by insurance or otherwise are fully deductible if (a) incurred in the taxpayer's trade or business, or (b) incurred in any transaction entered into for profit, or (c) arising from fires, storms, shipwreck, or other casualty, or theft, and a deduction therefor has not prior to the filing of the return been claimed for estate tax purposes in the estate tax return, or (d) if not prohibited or limited by any of the following sections of the Internal Revenue Code: Sections 23(g) and 117, relating to capital losses, section 23(h), relating to watering losses; section 24(b), relating to losses from sales or exchanges of property between persons designated therein; section 112, relating to recognition of gain or loss upon sales or exchanges of property; section 118, relating to losses on wash sales of stock or securities; section 251, relating to income from sources within possession of the United States; and section 252, relating to citizens of possessions of the United States. See section 213 as to limitation upon losses sustained by nonresident aliens.

In general losses for which an amount may be deducted from gross income must be evidenced by closed and completed transactions, fixed by identifiable events, *bona fide*, and actually sustained during the taxable period for which allowed. Substance and not mere form will govern in determining deductible losses. Full consideration must be given to any salvage value and to any insurance or other compensation received in determining the amount of losses actually sustained. See section 113(b). For special provisions with respect to war losses, see section 127.

* * * * * * *

Sec. 29.23(k)-6 (As amended by T. D. 5458, 1945-1 Cum. Bull. 45). *Non-Business Bad Debts.*—In the case of a taxpayer, other than a corporation, if a non-business bad debt becomes entirely worthless within a taxable year beginning after December 31, 1942, the loss resulting there-

from shall be treated as a loss from the sale or exchange of a capital asset held for not more than six months. Such a loss is subject to the limitations provided in section 117 with respect to gains and losses from the sale and exchange of capital assets. A loss with respect to such a debt will be treated as sustained only if and when the debt has become totally worthless, and no deduction shall be allowed for a non-business debt which is recoverable in part during the taxable year. Nor are the provisions of this subdivision applicable in the case of a loss resulting from a security as defined in section 23(k)(3). A non-business debt is a debt, other than a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business and other than a debt evidenced by a security as that term is defined in section 23(k)(3). The question whether a debt is one the loss from the worthlessness of which is incurred in the taxpayer's trade or business is a question of fact in each particular case. The determination of this question is substantially the same as that which is made for the purpose of ascertaining whether a loss from the type of transactions covered by section 23(e) is "incurred in trade or business" under paragraph (1) of that section.

The character of the debt for this purpose is not controlled by the circumstances attending its creation or its subsequent acquisition by the taxpayer or by the use to which the borrowed funds are put by the recipient, but is to be determined rather by the relation which the loss resulting from the debt's becoming worthless bears to the trade or business of the taxpayer. If that relation is a proximate one in the conduct of the trade or business in which the taxpayer is engaged at the time the debt becomes worthless, the debt is not a non-business debt for the purpose of this section.

To illustrate: A, an individual engaged in the grocery business and who makes his income tax returns on the

calendar year basis, extends credit on an open account to B in 1941.

(1) In 1942 A sells the business but retains the claim against B. The claim becomes worthless in A's hands in 1943. A's loss is controlled by the non-business debt provisions. While the original consideration was advanced by A in his trade or business, the loss was not sustained as a proximate incident to the conduct of any trade or business in which he was engaged at the time the claim became worthless.

(2) In 1942 A sells the business to C but sells the claim against B to the taxpayer, D. The claim becomes worthless in D's hands in 1943, at a time when D is not engaged in a trade or business incident to the conduct of which a loss from the worthlessness of such a claim would be a proximate result. D's loss is controlled by the non-business debt provisions, even though the original consideration was advanced by A in his trade or business.

(3) In 1942 A dies, leaving the business, including the accounts receivable, to his son, C, the taxpayer. The claim against B becomes worthless in C's hands. C's loss is not controlled by the non-business debt provisions. While C did not advance any consideration for the claim or acquire it in carrying on his trade or business, the loss was sustained as a proximate incident to the conduct of the trade or business in which he was engaged at the time the debt became worthless.

(4) In 1942 A dies, leaving the business to his son C, but the claim against B to his son, D, the taxpayer. The claim against B becomes worthless in D's hands in 1943, at a time when D is not engaged in a trade or business incident to the conduct of which a loss from the worthlessness of such a claim would be a proximate result. D's loss is

controlled by the non-business debt provisions, even though the original consideration was advanced by A in his trade or business.

(5) In 1942 A dies and while his executor, C, is carrying on the business, the claim against B becomes worthless. The loss sustained by A's estate is not controlled by the nonbusiness debt provisions. While C did not advance any consideration for the claim on behalf of the estate or acquire it in carrying on a trade or business in which the estate was engaged, the loss was sustained as a proximate incident to the conduct of the trade or business in which the estate was engaged at the time the debt became worthless.

(6) In 1942, A, in liquidating the business, attempts to collect B's claim but finds that it has become worthless. A's loss is not controlled by the non-business debt provisions, since a loss incurred in liquidating a trade or business is a proximate incident to the conduct thereof.

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